

GOVERNMENT INTERVENTION VERSUS DISCLOSURE: THE EVOLUTION OF CAPITAL MARKET REGULATION IN ISRAEL

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1. INTRODUCTION

During the past decade, Israel's financial system has undergone significant changes. Although the desirability of capital market reform is widely recognized, controversy persists regarding the extent to which steps taken during the second half of the 1980's adequately address the challenges Israel is now facing.¹ Israel is confronted with the unprecedented socio-economic task of absorbing as many as one million immigrants, many highly-trained professionals in the fields of science and technology, from the republics which until recently comprised the Soviet Union. In addition, the possibility of peace, or at least the cessation of periodic military conflict in the Middle East, could provide an opportunity for Israel to develop into a regional, and perhaps even an international, financial center.

The structure of Israel's financial system reflects, *inter alia*, a failure to resolve the conflict between two inherently contradictory perceptions of the appropriate role of government in the economy. The first calls for active government intervention in the allocation of capital based on the principle of centrally-directed economic development. The second emphasizes the need for "free market" allocation of resources tempered only by limited government regulation based on the principle of "full disclosure." Although significant steps have been taken to securitize the public debt, broaden participation in the market and enhance the integrity of market mechanisms, the basic contradiction that underlies Israel's regulatory philosophy remains unresolved.

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¹ For a detailed discussion of capital market reform in Israel, see THE FLOERSHEIMER INSTITUTE FOR POLICY STUDIES, CAPITAL MARKET REFORM IN ISRAEL (Marshall Sarnat ed. 1991).

This Article critically examines and evaluates the evolution of public regulation in Israel, and its impact on the capital market. It focuses on the scope and pace of legislative reform and the regulatory role of government, both prior and subsequent to the policy changes that were initiated by the Treasury, the Bank of Israel and the Securities Authority following the crash of the Tel Aviv Stock Exchange in 1983. The failure to reconcile the two diametrically opposing philosophies, more than any other single factor, has shaped, and continues to influence, capital market regulation in Israel. The consequences of this unresolved conflict affect Israel's ability to reach its domestic economic and political goals and to create for itself an appropriate niche in the emerging global market place.

2. THE MANDATE AND EARLY YEARS OF STATEHOOD

The emergence of a formal securities market in Israel is relatively recent, and can be traced back to the first half of the 1930's, during the British Mandate. In the years 1933 through 1937, significant amounts of capital were raised for the first time by public subscription in the domestic market. This rather abrupt emergence of a new issues market for securities reflected the transfer, by German Jewish immigrants, of their capital resources to Palestine after Hitler's rise to power.² To expedite the transfer, many German Jews purchased securities issued by local companies and institutions established expressly for this purpose. However, the purchase of these securities by these immigrants clearly had no economic motivation in the narrow sense of the term. Confronted by the great danger in waiting for a "cash transfer," they bought these securities, which were substantially over-priced, at a premium to expedite the capital transfer rather to make an investment. Perhaps the closest analogy is provided by compulsory loans demanded by governments in times of economic crises.

² See Marshall Sarnat, Note, *The Emergence of Israel's Security Market*, J. ECON. HIST. 693, 693 (1989); MARSHALL SARNAT, *THE DEVELOPMENT OF THE SECURITIES MARKET IN ISRAEL* (1966).

The Companies Ordinance of 1929³ provided a regulatory framework which governed the nascent securities market. This Ordinance was, in essence, identical to legislation that applied at the time throughout the British Empire. The Companies Ordinance stipulated various disclosure requirements; however, it did not assign responsibility for such regulation to any specific governmental department.⁴

The true emergence of the securities market in Palestine should be dated from the closing years of World War II, during which the country's leading industrial concerns tapped the domestic market for funds, and the primary motivation for investment and financing decisions was economic in nature. World War II also marks a turning point in governmental regulation. In 1941, an income tax was introduced, the Banking Ordinance⁵ was revised, and the Defence (finance) Regulations of 1941⁶ were issued. The latter required governmental approval of public security issues and also served as the basis for foreign currency control until their repeal in 1978.

The requirement for governmental approval of new issues, originally adopted by the Mandatory government as an emergency war-time measure, was carried over in 1948 to the new State of Israel. Subsequent approvals of securities issues were based largely on macro-economic considerations and the government's budgetary needs. Other aspects of raising capital—registration, prospectuses, and disclosure—were dealt with in The Israeli Companies Ordinance of 1929, which like the Defence Regulations, Income Tax Ordinance, and Banking Law were also incorporated by the new State.

In the mid-1950's, government intervention in the market became even more pronounced. In 1955, the government added regulations to the Insurance Business Control Bill of

³ See The Israeli Companies Ordinance of 1929, *LAWS OF PALESTINE: ORDINANCES*, vol. 1, chs. 1-66 (1933).

⁴ See JOSEPH GROSS, *SECURITIES AND STOCK EXCHANGE LAW* 20 (1973).

⁵ See The Israeli Banking Ordinance of 1941 No. 1118, *THE PALESTINE GAZETTE* 747, 750-59 (1941).

⁶ See Defence (finance) Regulations of 1941 No. 1138, *THE PALESTINE GAZETTE* 1635, 1647-59 (Supp. II 1941) [hereinafter Defence Regulations].

1951,⁷ requiring minimal levels of compulsory investment by insurance firms in government or government-guaranteed securities. The Encouragement of Savings Law of 1956 established tax ceilings on approved securities, and set out restrictions on the investment policies of savings plans.⁸ In 1957, the Treasury issued special income tax regulations relating to the activities and investment policies of provident, pension, severance pay and annual leave funds.⁹

The overall effect of these laws and regulations was to greatly reduce the discretionary investment activities of institutional investors. Government controls related to both the supply and demand of funds. On the supply side, new issues required government approval under the Defence Regulations. On the demand side, institutional investors were required to invest significant percentages of their capital in "approved" securities. These restrictions came at a time, when due to high inflation and the subsequent introduction of indexation on a broad scale, security issues by the private sector were all but non-existent.

The early years of statehood were marked by an unprecedented volume of immigration, an inflationary spiral, and a more than five-fold devaluation of the external value of the currency. Both the bond and equity markets were unable to cope with the unstable economic environment, and the total amount of capital raised in the domestic market was grossly inadequate to finance the massive waves of immigration. Israel did not have a *separate* securities law; legal matters pertaining to such things as the Stock Exchange, securities transactions, new issues, and corporate reporting were dealt with in existing economic legislation carried over from the British Mandate.¹⁰

In the latter part of the 1950's, two advisory committees were set up in the Ministry of Finance for the supervision and

⁷ See Regulations to the Insurance Business Control Bill of 1951, 490 KOVETZ HATAKANOT 258 (1954).

⁸ See Encouragement of Savings Law of 1956, 10 LAWS OF THE STATE OF ISRAEL 49-67 (1955-56).

⁹ Rules for the Approval of Provident, Pension and Severance Pay Funds of 1957, 726 KOVETZ HATAKANOT 1826-31 (1956-57).

¹⁰ See Haim Ben-Shahar, Saul Bronfeld & Alexander Cukierman, *The Capital Market in Israel*, in ISRAEL AND THE COMMON MARKET (Pierre Uri ed., 1971).

evaluation of new issues. The New Issues Committee was comprised of representatives of the Treasury, Bank of Israel and the Investment Center (another governmental department). Its task was to review new issues within the framework of the Ministry's authority under the Defence Regulations. More specifically, the New Issues Committee was responsible for evaluating new issues in terms of their impact on the Israeli economy and economic policy. The second committee, the Securities Committee, included representatives from the Treasury, Bank of Israel, and Ministry of Industry and Trade, as well as the banking community, corporations, and the public. The Securities Committee was assigned the task of checking prospectuses. The scope of the two committees' activities can be inferred from the fact that they were both serviced by an office within the Ministry of Finance which employed only one lawyer and one accountant at the time.¹¹

3. THE SECURITIES LAW

A new issue of common stock by the American-Israel Paper Mills in 1959 signaled a dramatic revival of the stock market. Between 1959 and 1964, 118 new issues of common stock were floated in the domestic market.¹² The expansion of the stock market, accompanied by an unprecedented rise in share prices and trading volume, focused attention on the need for a more formal definition in law of the role of the securities market. In 1961, the Joint Investments Trust Law was enacted.¹³ This law, regulating the investment activities of mutual funds, stipulated that the mutual fund managers invest in securities listed on the Tel Aviv Stock Exchange.¹⁴ It also established ceilings on the amount an individual fund could hold in a given company's securities and prohibited the issue of closed-end investment funds.

In 1962, the Ministry of Finance appointed the Commission on New Issues and Trading (the "Yadin Commission") to

¹¹ See REPORT OF THE COMMISSION FOR NEW ISSUES AND TRADING 5 (June 1963).

¹² SARNAT, *supra* note 2, at 47.

¹³ See Joint Investments Trust Law of 1961, 15 LAWS OF THE STATE OF ISRAEL 79-89 (1960-61).

¹⁴ *Id.* at 79, 83.

examine the legal and administrative foundations of both the primary and secondary markets. The Yadin Commission also explored alternative arrangements for the regulation of security market activities "with a view to protecting the interest of investors in shares and other securities."¹⁵ The Yadin Commission heard testimony from experts from the United States including Professor Louis Loss and former Securities and Exchange Commission chairman Manuel Cohen. The Yadin Commission's report, which was presented to the Minister of Finance in June 1963, emphasized the need to create public confidence in Israel's securities market. Manuel Cohen summarized the Yadin Commission's goals as follows:

[W]hile there are no serious abuses as yet, it is better to have the law and anticipate the abuses Israel has a problem in the fact that its population consists of people from all over the world. You are trying to marshall their savings and encourage investment in securities, a concept which many of them do not understand and, because they do not understand, suspicion exists. To the extent that you are in a position to tell the public that you have erected a structure and adopted a law designed for their protection, you will have a better chance of encouraging local investment. Finally, Israel is interested in encouraging portfolio investment from abroad. In the U.S. and England you will instill confidence if people know that you have erected a structure of control which provides a real measure of protection.¹⁶

The Yadin Commission's principal recommendations included:

- a. Adoption of the American version of full disclosure as the underlying philosophy for securities regulation.
- b. Establishment of a Securities Authority to supervise activities in the primary and secondary markets.
- c. Establishment of the new Securities Authority as a separate regulatory agency.

¹⁵ REPORT OF THE COMMISSION ON NEW ISSUES AND TRADING, *supra* note 11, at 1.

¹⁶ *Id.* at 4.

d. Retention of the status of the Stock Exchange as a self-regulating body, subject to public review.¹⁷

The Yadin Commission's report also included draft legislation which became the basis of the 1968 Securities Law.¹⁸

The Securities Law embraced the U.S. philosophy of securities legislation: full disclosure of, and equal access to, all material information, and the legal accountability of all participants involved in the investment process.¹⁹ The philosophy of "full disclosure" was adopted as it endeavored to protect the investors' interests while enhancing market efficiency. The philosophy is based on the notion that timely disclosure of all material information is the mechanism by which these goals are to be achieved. Theoretically, other impediments were to be kept at the minimum necessary to ensure the operations of a free market. Thus, the new approach embracing "full disclosure" eschewed, as a matter of principle, direct governmental intervention where the primary focus of securities regulation was placed on the quality and frequency of information and on the integrity of the institutions and personnel involved in the primary and secondary markets.

Israel's 1968 Securities Law and subsequent secondary legislation radically differed from the interventionist approach that pervaded the previous legislation and administrative arrangements. But instead of replacing traditional regulatory thinking, "full disclosure" was *superimposed* on an "administered" market. Section 8 of the Defence Regulations, which required government approval for securities issues, remained in force and was later incorporated as an amendment to section 39 of the Securities Law. Moreover, the system by which the government controlled both the supply and demand for capital persisted.

Thus, Israel's new securities law did not come to grips with the fundamental paradox inherent in basing regulation partly on the Anglo-American philosophy of free market allocation and partly on the "socialist" or "paternalistic" principle of

¹⁷ *Id.*

¹⁸ See Securities Law, 22 LAWS OF THE STATE OF ISRAEL 266-81 (1967-68).

¹⁹ See LOUIS LOSS, SECURITIES REGULATION 121-28 (2d ed. 1961).

administered markets. The 1968 law charged the newly created Securities Authority with the protection of investors' interests, based on full disclosure and directed that the Ministry of Finance handle those activities involving the channelling of capital. This separation of functions reflected the underlying philosophy of the Yadin Commission: "Despite the fact that all agencies are working within the same general governmental framework, separation is desirable to reflect the various aims of each body. It is unhealthy that differing considerations be intertwined."²⁰

With this view in mind, the Securities Authority was established as a separate statutory body subject to review by the State Comptroller, and was provided with broad powers to protect the interests of investors in both the primary and secondary markets. The new Authority had the potential to become a major factor in Israel's capital market, but the Authority did not live up to this potential. Throughout the 1970's and the first half of the 1980's the Securities Authority played a marginal role in the development of Israel's emerging market. It tended to take a technocratic stance with regard to full disclosure. If a prospectus included the technical accounting details specified in the Securities Regulations, it was usually approved without significant debate. Little attention was given to the quality of information disclosed in the prospectus as a whole. Even less attention was given to material omissions from the prospectus and periodic financial reports.²¹

In a report following the bank share crisis, the State Comptroller cited the failure of the Securities Authority to fulfill its functions with regard to the banks' intervention in the trading of their stock.²² In 1986, a judicial commission of enquiry (the "Commission of Enquiry") concluded that the Securities Authority had failed in *all* of the areas in which it was empowered by law to operate. The Commission of

²⁰ See Uriel Yadin, *The Yadin Commission—It's Operations and Conclusions*, in THE YADIN COMMISSION ON THE SECURITIES MARKET IN ISRAEL: A COLLECTION OF LECTURES 13 (1964).

²¹ See REPORT OF THE COMMISSION OF ENQUIRY INTO THE INTERVENTION IN THE TRADING OF BANK SHARES, ch. 20 (Apr. 1986) [hereinafter COMMISSION OF ENQUIRY REPORT].

²² See ISRAEL STATE COMPTROLLER'S OFFICE, REPORT ON THE BANK SHARES: THE OCTOBER 1983 CRISIS 12 (1984).

Enquiry found that: "[t]he Authority, which was established to protect the public, surrendered, without opposition, to the demands of both internal and external pressure groups. As a result, the public was left defenseless."²³

With the exception of Amendment 6 to the Securities Law, which placed specific prohibitions on the abuse of insider information,²⁴ few substantive changes were made to the Law itself. Secondary legislation concentrated primarily on technical accounting issues, while some of the major legal issues of the Securities Law such as government manipulation of the market, due diligence and accountability were left untouched. The number of civil and criminal court cases dealing with securities violations were few, and even today there is a paucity of judicial decisions that can serve as an accepted basis for interpreting many facets of the law.

The excessive volatility generated by periodic "booms and busts" on the Tel Aviv Stock Exchange during the late 1970's and early 1980's, spawned numerous public committees and commissions. More often than not, they tended to come down on the side of the status quo.²⁵ The fundamental contradiction between two competing philosophies of regulation—substantive government control of new securities issues versus a free market philosophy tempered only by limited government interference based on the principles of full disclosure—remained unresolved.

4. THE 1983 BANK SHARE CRISIS

Like those of many European and developing countries, Israel's financial markets are dominated by commercial banks operating under a system of universal banking which does not separate commercial from investment banking activities. The historical development of the country's banks created a highly centralized structure in which a small number of banking institutions dominate both commercial banking and the capital markets. The commercial banks and their subsidiaries

²³ See COMMISSION OF ENQUIRY REPORT, *supra* note 20, at 319.

²⁴ See Securities Law, 35 LAWS OF THE STATE OF ISRAEL 319-29 (1968), amended by ch. 8A, §§ 52a-j (1981).

²⁵ For a detailed description of the various public commissions, see Marshall Sarnat & June Dilevsky, *The Development of Capital Market Regulation in Israel*, Q. BANKING REV., Dec. 1991, at 11.

dominate the mortgage, insurance, securities brokerage, and underwriting markets as well as the management of mutual investment funds and retirement funds.

Starting in the early 1970's, Israel's leading commercial banks, followed later by several smaller banks, began to systematically support the prices of their own shares on the stock exchange.²⁶ In the summer of 1983, expectations of a major devaluation motivated investors to sell their bank shares on the Exchange in favor of dollar-linked assets. The banks soon found themselves saddled with over \$900 million worth of repurchased shares,²⁷ but without the financial means to continue their policy of price support. To avert a collapse of bank share prices, the government intervened and initiated an "arrangement" under which the bank shares were, in effect, converted into government bonds.

In many ways 1983 signifies for Israel what the year 1929 represents for the United States. As a result of two successive stock exchange crashes, first in the market for non-bank shares and later in the year in the market for bank shares, stock prices fell on average by 70 percent (in dollar terms) and the ownership (but not control) of the banking system was transferred to the government. In 1984, the State Comptroller issued a report on the bank share crisis that engendered a heated public debate which culminated in the appointment, in January 1985, of a judicial commission of enquiry.

5. THE REGULATORY ENVIRONMENT FOLLOWING THE FINANCIAL CRISIS

1983 also marks a watershed in the evolution of regulatory thinking and practice in Israel. The financial crisis and the publication of the Commission of Enquiry's report accelerated the pace of capital market reform. Between 1984 and 1986, various regulatory agencies and the Tel Aviv Stock Exchange

²⁶ See COMMISSION OF ENQUIRY REPORT, *supra* note 20 (description of the events leading to the bank share crisis).

²⁷ The Israeli Companies Ordinance of 1929, *supra* note 3, art. 98 (current version at art. 139 (1983)) forbids the repurchase of shares by the issuing firm. The commercial banks circumvented this restriction by repurchasing shares through subsidiaries, some of which were established specifically for this purpose. See COMMISSION OF ENQUIRY REPORT, *supra* note 20.

introduced a series of administrative changes.

The Stock Exchange established disclosure requirements regarding insider trading, set up standards for price stabilization practices, adopted rules governing portfolio management by members, issued directives prohibiting listed firms from paying "management fees" to major stock holders, and required Exchange approval of all tender offers.²⁸

The Bank of Israel placed limits on the underwriting activities of commercial banks and issued directives concerning the investment advice offered by the banks to their customers.²⁹ The new regulations stipulated that bank-employed investment advisors must reveal all pertinent information regarding the recommended investment advisor, particularly with respect to high-risk investments. In addition, the Central Bank's direct intervention in the open market for medium and long-term government securities was drastically reduced. Monetary policy was also liberalized and initial steps were taken to reduce foreign currency restrictions.

In the spring of 1987, the Treasury suspended the requirement of prior approval for individual bond issues by granting a "general permit" for (non-bank) corporate stock and bond issues. The tax status of corporate bonds was changed to put them on equal footing with government issues.³⁰ At the same time, the Treasury embarked on a policy to "securitize" the national debt and relax, but not relinquish, controls over the investment policies of major institutional investors.

For its part, the Securities Authority issued new regulations requiring the immediate disclosure of significant corporate events including in-process negotiations and more specific disclosure of the intended uses of offering proceeds.³¹

²⁸ See generally THE TEL AVIV STOCK EXCHANGE, MONTHLY REV.

²⁹ Rules of Banking (Investment Advisors), Regulations Under the Banking (Service to Customer) Law of 1986, 4931 KOVETZ HATAKANOT 867-68 (1986).

³⁰ A ceiling of 35% was placed on the interest accrued on all zero-coupon corporate bonds. Consequently, corporate issues were considered "preferred loans," a status which eliminated taxation on nominal gains from linkage. Previously, a company was required to receive explicit permission from the Knesset Finance Committee; however, the Finance Committee reserved its right to refuse the granting of the 35% tax ceiling. See Regulations to the Encouragement of Savings Law of 1987, 5039 KOVETZ HATAKANOT 1047 (1987).

³¹ See generally SECURITIES AUTHORITY, NEWSLETTER.

This combination of largely uncoordinated piecemeal measures (often referred to in Israel as "capital market reform") had a major impact on Israel's financial markets during the second half of the 1980's. This is especially true with respect to the market for corporate bonds which barely existed until the reform.³² Yet, despite a significant reduction in governmental intervention, capital market reform did not herald a qualitative change in regulatory thinking. Many of the measures employed had traditionally been part of the Finance Ministry's and Bank of Israel's arsenal; and their usage often reflected adaptation to changing market conditions rather than fundamental shifts in public policy.

However, more substantive advances in the regulatory climate have occurred since 1987, spearheaded by the newly-appointed Chairman of a reorganized Securities Authority. In recent years, the Authority has become a more viable and assertive regulatory agency, and has been instrumental in enhancing professional standards and changing behavioral norms. Major changes can be discerned in the following areas:³³

- Examination of prospectuses and the enhancement of the quality and timeliness of the flow of information.
- Establishment of corporate accounting standards.
- Enforcement of restrictions on insider trading and stock price manipulation.
- Supervision of the Tel Aviv Stock Exchange.
- Promotion of new legislation.

6. NEW SECURITY MARKET LEGISLATION

The transformation of the Securities Authority also triggered a major revision of Israel's securities legislation. Amendment 9 to the Securities Law,³⁴ which was ratified in

³² In the early 1980's, the Ministry of Finance began to approve, on a limited scale, corporate bond issues linked to the exchange rates of foreign currencies. In 1984, the Knesset passed a law to encourage the issue of "security packages," which included corporate bonds, to encourage research and development. See Law for the Encouragement of Industrial Research and Development of 1984, 38 LAWS OF THE STATE OF ISRAEL 130-45 (1983-84). Approval of such issues was curtailed in 1986.

³³ See Sarnat & Dilevsky, *supra* note 24.

³⁴ Securities Law, amend. IX, 1261 SEFER HAHOKIM 188-211 (1988).

1988, altered most of the original articles in some way; however, the underlying philosophy of full disclosure remained intact. Amendment 9 increased the Securities Authority's powers in selected areas. But for the most part, the amendment, along with its subsequent secondary legislation, has more clearly defined rather than changed the Authority's regulatory powers vis-a-vis issuing firms, the Tel Aviv Stock Exchange,³⁶ and independent professionals involved in the primary market. In addition, the amendment has extended the legal accountability of the owners and managers of public companies as well as independent professionals involved in the primary market.³⁶

The 1988 amendment also introduced a standardized framework for class action suits initiated by minority shareholders for damages resulting from infringements of the Securities Law or fiduciary duties.³⁷ Although existing corporate legislation included remedies for minority grievances against discriminatory "mismanagement,"³⁸ class actions, as specified in the amended Securities law, was viewed as a way to *facilitate* the process of civil litigation. The new law not only specified the conditions under which class action is possible, but also stipulated that in certain cases the Securities Authority can choose to participate in the financing of class action suits.³⁹

Other major changes introduced by Amendment 9 included:

- Trust indenture provisions requiring mandatory appointment of an independent trustee by the issuers

³⁶ Amendment XI, ratified at the close of 1990, further clarifies the areas of authority granted the Tel Aviv Stock Exchange. See Securities Law, amend. XI, 1334 SEFER HAHOKIM 22-28 (1990).

³⁷ Amendment IX globalized responsibility of signatories of a prospectus for the content of the entire document. See Securities Law, *supra* note 33, § 32. Amendment X, passed in 1990, tempered this responsibility as it applies to independent professionals whose opinion appears in the prospectus. See Securities Law, amend. X, 185 SEFER HAHOKIM 185-86 (1990).

³⁸ See Securities Law, *supra* note 33, §§ 54a-k.

³⁹ Prior to Amendment IX, class action suits were possible, but plaintiffs were not compensated for damages. In addition, under certain circumstances, minority shareholders may now sue management in the name of the company via derivative suits.

⁴⁰ See Securities Law, *supra* note 33, § 54g.

of corporate bonds.⁴⁰

- Provisions enabling the Securities Authority to set accounting standards for the financial reporting of public firms in instances where no recognized standards exist.⁴¹

- Provisions extending the liability of public issuers of securities. This liability, which previously covered only investors who purchased securities at issue, was broadened to cover transactions in secondary markets.⁴²

- Provisions to insure the independence of the Board of Directors of the Tel Aviv Stock Exchange, including a requirement that the Exchange's Board be comprised of a majority of external directors.⁴³

Another major legislative change occurred at the end of 1990 with the ratification of Amendment 11.⁴⁴ A decision by the Tel Aviv District Court⁴⁵ challenging the authority of the Exchange to regulate the governance structure of listed firms provided the catalyst for this amendment.⁴⁶ The Court, in this case, upheld the plaintiffs' claim regarding the limited extent of the Exchange's authority, but the implications of the decision extended beyond the specific Exchange directive contested in court.

In 1989, the Stock Exchange issued a directive equalizing the voting rights of listed firms. According to this directive, new public corporations could issue only one class of shares, and existing dual-class corporations could only issue the class

⁴⁰ *Id.* §§ 35a-p.

⁴¹ *Id.* § 36a.

⁴² *Id.* at art. 31(a).

⁴³ In order to qualify as an external director, a candidate cannot be employed by a member of an Exchange and cannot serve a member of an Exchange as a consultant on any regular basis. *See id.* § 45a.

⁴⁴ *See* Securities Law, *supra* note 34, at 22-27.

⁴⁵ *Nimrodi Land Development, Ltd. and Hachsharat Hayishuv, Ltd. v. Tel Aviv Stock Exchange, Ltd.*, 272 P.D. 89 (Tel Aviv District Court 1990) (Israel).

⁴⁶ The plaintiffs were arguing against a Stock Exchange directive denying approval of a securities issue. The directive required that a majority shareholder in possession of founders' shares which guarantee at least 50% of the vote hold at least 25% of the capital of the firm. *Id.*

with superior voting rights. Because the directive might be construed as a failure to comply with the spirit of the above ruling of the District Court, Amendment 11, which details and limits the areas of Stock Exchange responsibility, explicitly incorporated this directive into the Securities Law.

In addition to these changes in primary security legislation, revisions to the secondary legislation under the Foreign Currency Control Law have been made in an attempt to gradually "re-liberalize" Israel's foreign currency regime.⁴⁷ In 1989, foreign residents were extended the right to repatriate investments made in corporate bonds issued by Israeli firms⁴⁸ and Israeli mutual funds were granted permission to invest in securities listed on foreign exchanges.⁴⁹ In 1990, Israeli companies were granted blanket permission to list shares on recognized foreign exchanges (including the OTC market in the United States). Additionally, Israeli residents were permitted to invest in these shares.⁵⁰

The continuing dilemma between a regime based on free market mechanisms and one permeated by governmental intervention is also evident in legislation regarding corporate mergers. In 1988, a new Restricted Trade Law⁵¹ was passed replacing earlier legislation designed to monitor the merger activities of monopolies. The new law required the approval of the Ministry of Industry and Trade for all mergers where the combined assets of the merging parties exceed a minimal

⁴⁷ In October 1977, some foreign currency controls were relaxed. Israelis were permitted to hold foreign currency accounts in Israel as well as limited sums abroad, to conduct local transactions in foreign currency, and to purchase foreign securities. Similarly, foreign residents were permitted to invest in both equity and non-equity instruments issued locally by Israeli companies. However, between 1978-1984 restrictions on these activities were gradually reintroduced. See ZEBULEN HANDLER & JOSEPH SHEFET, *THE CONTROL OF FOREIGN CURRENCY*, vols. 1-3 (1991) (unofficial English translation).

⁴⁸ See General Permit of the Foreign Currency Control Law, §§ 1, 11 (1978).

⁴⁹ See *hozrei hamefakeach al hamatbea chutz, nosach meshulav*, (Memoranda of the Controller of the Foreign Currency), ch. 6, at 4 (1989).

⁵⁰ See General Permit of the Foreign Currency Control Law, *supra* note 47, § 5(7)(a). Before this change, a company had to receive special permission to list shares or raise capital abroad. Moreover, special permission was required before Israeli residents were allowed to invest in these shares.

⁵¹ Restricted Trade Law of 1988, 1258 SEFER HAHOKIM 128-40 (1988).

amount (originally set at three million dollars).⁵² And this trend is not limited to mergers. Currently, legislation is pending which addresses specific areas of the securities industry, including provisions relating to mutual funds, investment advice and portfolio management. These provisions, if adopted, would increase the Ministry of Finance's discretion over market operations.⁵³

7. SOME CONCLUDING REMARKS

During the past decade, many significant legislative decisions and administrative steps have been taken with a view to reforming Israel's capital markets. Despite the many changes in the regulatory environment, the basic conflict between the two competing philosophies of public regulation remains unresolved. In the absence of a more fundamental change in the underlying philosophy governing capital market regulation, some doubt arises with respect to the permanence of the reforms, especially if the need to fund a large government budgetary deficit should arise.

Many of the new "reform measures" are not qualitatively different from similar steps adopted in the past to encourage domestic and/or foreign investment. The suspension of the requirement of Treasury approval of new security issues, the relaxation of the mandatory investment requirements imposed on institutional investors, and the changes in foreign currency regulations have all been adopted, at one time or another in the past, and later rescinded. Moreover, despite the major revisions that had been made in the Securities Law, the Ministry of Finance's authority to reimpose controls over the supply of capital, as provided in Article 39 of the Securities Law, remains intact.

Israel's 1983 financial crisis reflected a failure to enforce

⁵² *Id.* § 4.

⁵³ See Law for the Regulation of Investment Advisors and Portfolio Managers, 1857 HATZAAT HOK [Knesset Bill] 29-46 (1987); Joint Investment Trust Law, TAZKIR HOK (proposed Nov. 4, 1990). The proposed laws provide the legal framework for regulation of investment advisory services and mutual fund management. Both laws restrict the daily operations of brokers and mutual fund managers in various ways and both grant the Minister of Finance discretionary powers in areas such as the determination of brokerage commissions and the composition of mutual funds.

existing laws; it was the “spirit” of the law, and not the law itself, that was missing.⁵⁴ Massive governmental intervention did not prevent, and arguably was one of the causes of, the collapse of the financial system. Recognition of this aspect of the crisis reinforces the argument that legislation, public regulation, and direct governmental intervention should be limited to the minimum necessary to provide an appropriate framework and suitable environment for the efficient functioning of a free market. Beyond that, Israel must confront the fundamental paradox inherent in basing its regulatory framework on a “two-edged sword,” and learn to depend on market forces to provide the guidelines for future investment and financing decisions.

⁵⁴ COMMISSION OF ENQUIRY REPORT, *supra* note 20, at 348-49.